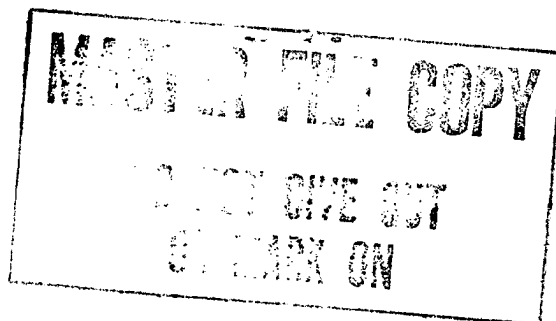




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## South Korea: Managing a Large Foreign Debt

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An Intelligence Assessment

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EA 83-10245  
December 1983

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# **South Korea: Managing a Large Foreign Debt**

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**An Intelligence Assessment**

This paper was prepared by [redacted]  
Office of East Asian Analysis. Comments and queries  
are welcome and may be directed to the Chief,  
Northeast Asia Division, OEA, [redacted]

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**South Korea: Managing a  
Large Foreign Debt**

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**Key Judgments***Information available  
as of 2 December 1983  
was used in this report.*

South Korea, whose \$37.2 billion foreign debt is the third largest among developing countries, has implemented a broad-based austerity program that substantially reduces—but does not remove—the possibility of a debt financing crisis over the next several years. Since 1979, Seoul has dramatically slowed the growth in government spending, the money supply, and wages. The austerity measures have bolstered South Korea's already strong international credit rating and held down new borrowing.

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Seoul's short-term debt, which has increased from 25 percent of the total in 1978 to 40 percent last year. The United States, which holds about 40 percent of South Korea's debt, would be under the strongest pressure to provide emergency assistance in the event of a South Korean debt problem.

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The Chun government is pressing ahead with further austerity measures and new efforts to help curtail future borrowing needs:

- Government spending in 1984 will be held at the 1983 level and the deficit reduced from 4 percent of GNP to 2 percent of GNP.
- Numerous industrial and infrastructure projects, including nuclear power plants, have been delayed.
- Restrictions have been placed on the private sector's short-term borrowing.

The economy has responded well to the government's policy mix and is now on a sounder footing than it was in the late 1970s when debt was mushrooming:

- Inflation has been reduced from 30 percent in 1980 to less than 5 percent.
- The current account deficit has been cut from more than \$5 billion in 1980 to \$2 billion, reducing the need for balance-of-payments financing.
- Real GNP has increased 9 percent.

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Any one of several economic events, however, could undermine banker confidence and Seoul's efforts to obtain financing:

- An aborted global recovery or a rapid runup in oil prices.
- The failure of South Korea's plan to push into skill-intensive industries as a way to expand exports.

Political developments, even with solid economic fundamentals, could precipitate a debt crisis. Signs of instability in the Chun government or a series of terrorist acts by North Korea to disrupt the Chun regime could cause creditors to pull back.

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## South Korea: Managing a Large Foreign Debt

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### Foreign Debt Position

In the wake of debt financing problems in Brazil, Mexico, and, now, the Philippines, South Korea has come under increasingly close scrutiny by the international financial community. [ ] concerns center on the size and maturity structure of South Korea's debt:

- South Korea's foreign debt has increased dramatically over the past decade, reaching \$37.2 billion in 1982, the third largest among developing countries. Seoul's decision in the early 1970s to use foreign borrowing to speed economic development and the two oil shocks are responsible for this rapid growth.
- Debt service payments have more than doubled since 1978, reaching \$5.9 billion last year. The debt service ratio, however, has only increased from 13 percent in 1978 to 21 percent last year, remaining below the LDC average.<sup>1</sup>
- The maturity structure of the debt has shortened considerably over the past five years, with short-term debt increasing from 25 percent of the total in 1978 to 40 percent last year. The availability and low cost of short-term funds are the primary reasons for this rapid growth. [ ]

### Beginnings of Austerity

Aware that the rapid increase in debt was unsustainable, Seoul began an austerity program in the late 1970s to hold down new borrowing by dampening import demand and strengthening export competitiveness. In early 1979 the Park government tightened fiscal and monetary positions, curtailed labor costs, and slowed private investment plans. The Chun government, which came to power in 1980, strengthened these policies, further cutting the growth in government spending, the money supply, and wages. As a result, real GNP grew by only 1.7 percent per year during 1980-82, import volume fell 3 percent during the same period, and real wages declined 7 percent

<sup>1</sup> Including interest payments on the short-term debt. [ ]

**Table 1**  
**LDCs: Major Debtors,**  
**Ranked by Total Debt,**  
**Yearend 1982**

Billion US \$

Brazil	85.4
Mexico	83.1
South Korea	37.2
Argentina	36.7
Venezuela	33.7
Indonesia	23.5
India	21.5
Egypt	21.5

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during 1980-81. Seoul also forced the won to depreciate to increase export competitiveness. Since 1979, the won has depreciated about 40 percent against the dollar. Even on a trade-weighted, price-adjusted basis, the won depreciated about 10 percent between the fourth quarter of 1979 and the first quarter of 1983.<sup>2</sup>

The government's policy mix has won praise from the IMF and foreign lenders and restored rapid economic growth. We expect real GNP will advance 9 percent or more this year and 8 percent in 1984, putting South Korea once again among the world's growth leaders. Perhaps of even greater importance, inflation has been reduced from 30 percent in 1980 to less than 5 percent. [ ]

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The foreign sector has responded well to Seoul's policies. Export volume has increased about 50 percent during 1980-83, despite slow growth in world

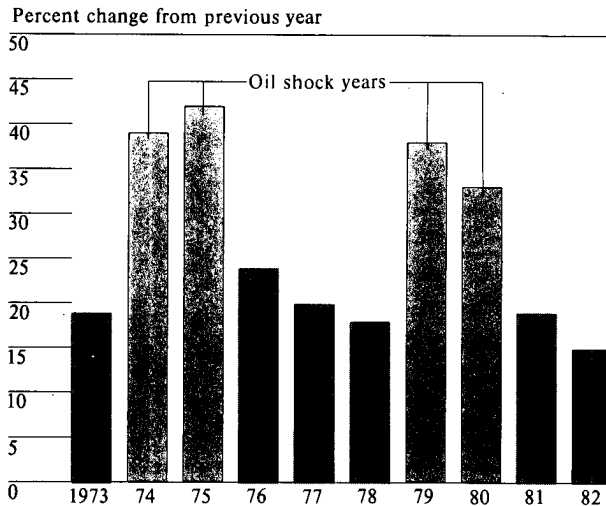
<sup>2</sup> The trade-weighted, price-adjusted exchange rates relates the Korean won to the currencies of its trading partners, weighted by the percentage of trade with each partner, and adjusts this rate based on differences in relative inflation rates. [ ]

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**Figure 1**  
**South Korea: Growth of Foreign Debt**



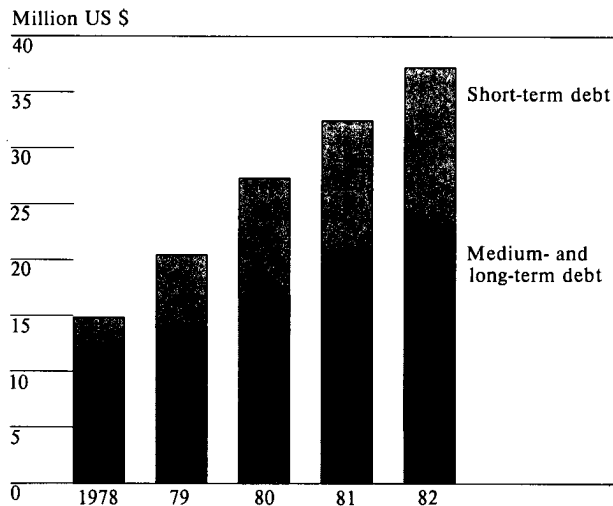
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trade. The strength in foreign sales reflects the competitiveness of South Korea's export sector resulting from the won devaluation and Seoul's diversification of its export base. A doubling in ship exports last year, for example, bolstered foreign exchange earnings at a time when sales of textiles, electronics, and other consumer goods declined. South Korean exporters have also proved adept at finding new markets for their products in Third World countries, particularly in Asia and Africa.

#### **Chun's Austerity Plans**

The Chun government plans to continue tight fiscal and monetary policies in 1984 to strengthen export competitiveness and slow import demand. An austere budget has been announced for 1984 that will hold government spending at the 1983 level and reduce the government deficit from 4 percent to 2 percent of GNP. Seoul is also taking gradual steps to eliminate many of the subsidies that have contributed to the fiscal deficits. The growth in the money supply, which

**Figure 2**  
**South Korea: Foreign Debt, by Maturity**



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has been halved from the 29-percent annual average of 1978-82 to 15 percent this year, will be further reduced in 1984. In addition, Seoul will continue to exert pressure to hold down labor costs; wage increases have slowed from 24 percent annually in 1978-82 to 12 percent in 1983. Through these policies, the Chun government hopes to cut inflation to 2 percent—or even zero—next year.

For 1984-86—the last three years of the current five-year development plan—Korean economic planners are revising policies to reduce foreign financing needs. Seoul hopes to meet these targets by:

- Delaying or canceling industrial and infrastructure projects. According to press reports, about half of the foreign-financed projects planned for the next five years will be postponed.

**Table 2**  
**South Korea: Debt Service**

*Billion US \$*

	1979	1980	1981	1982	1983 <sup>a</sup>	1984 <sup>b</sup>
Principal repayment	1.6	1.5	2.0	2.1	2.5	3.0
Interest payments	1.4	2.6	3.7	3.8	3.6	4.1
On short-term debt	0.4	1.2	1.9	1.5	1.5	1.4
On medium- and long-term debt	1.0	1.4	1.8	2.3	2.1	2.7
<b>Total</b>	<b>3.0</b>	<b>4.1</b>	<b>5.7</b>	<b>5.9</b>	<b>6.1</b>	<b>7.1</b>
Debt service to exports of goods and services ratio (percent)	15.2	18.4	20.7	20.9	19.5	20.0

<sup>a</sup> Estimated.

<sup>b</sup> Projected.

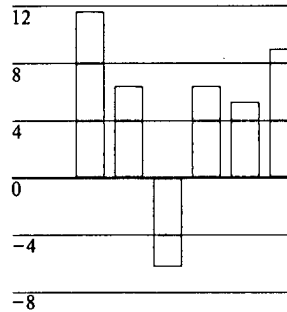
- Putting increased emphasis on expanding exports by improving quality, enhancing price competitiveness, and stepping up marketing activity. By moving into more technology-intensive products, Seoul believes it can boost exports 10 percent annually over the next three years.<sup>3</sup>
- Enacting policies to slow import demand. These include tougher energy conservation measures to reduce oil imports and increased efforts at rice self-sufficiency to curtail foreign grain purchases.
- Boosting domestic savings by maintaining positive real interest rates and expanding financial instruments. An increase in the domestic savings rate from the 20 percent of GNP level of recent years to 30 percent by 1986 is planned.

By delaying big ticket industrial and infrastructure projects, Seoul will save considerable foreign exchange. Plans for four nuclear power plants, valued at more than \$5 billion and originally scheduled for construction beginning in 1983 and 1984, have been pushed back until at least 1986. Capacity will grow

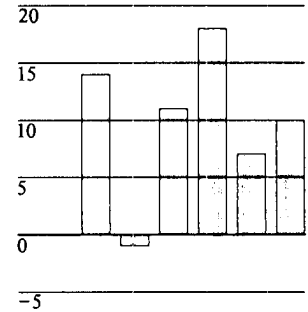
**Figure 3**  
**South Korea: Major Economic Indicators**

Percent

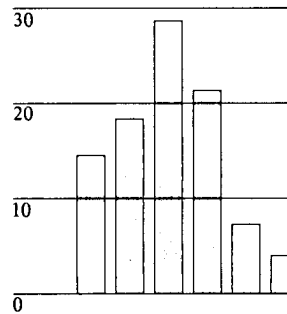
**Real GNP Growth**



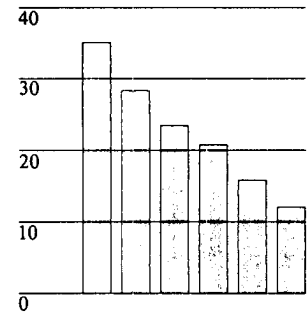
**Export Volume Growth**



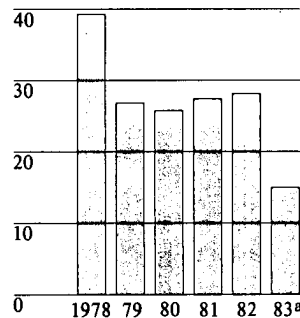
**Consumer Price Inflation**



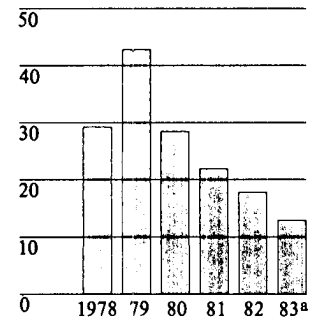
**Nominal Wage Growth**



**Money Supply Growth**



**Growth in Government Spending**



<sup>a</sup> Projection.

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more slowly than earlier projections indicated in the auto, shipbuilding, and steel industries. Delays have also been announced for expensive infrastructure projects, including a high-speed rail link between Seoul and Taejon in central Korea and for a second subway line in the southern city of Pusan. [ ]

Seoul has also enacted policies to discourage short-term borrowing to improve the maturity structure of the debt. According to press reports, these measures include shortening the repayment period for trade credits and limiting the types of goods for which such credits will be permitted. Seoul is committed under its IMF agreement to reducing the short-term debt in absolute terms and as a share of the total debt. [ ]

In addition, South Korean economic planners are liberalizing foreign investment regulations to attract more equity investment in place of foreign loans. The Chun government hopes to boost foreign investment from the \$100 million a year average of recent years to \$700 million per year by 1986. To encourage this expansion, the Ministry of Finance has proposed changes in investment rules that would (a) permit foreign investment in all sectors of the economy not specifically restricted—currently only selected areas are open to foreign investment, (b) make investment approvals routine for joint ventures with less than 50-percent foreign ownership, and (c) eliminate restrictions on profit and capital remittances. [ ]

#### **Financing Needs**

Even with its policies to curtail foreign borrowing, we believe that South Korea will need about \$6.5 billion annually in foreign capital over the next three years if it is to achieve its goal of high economic growth. This would enable Seoul to cover its current account deficit, meet principal repayments, maintain a reasonable level of foreign exchange reserves, and provide for exports on credit (see table 3). [ ]

We believe South Korea's policies will gradually reduce the current account deficit over the next several years, assuming relatively stable oil prices and continued global recovery. The deficit, which peaked at \$5.3 billion in 1980 (9 percent of GNP), declined to \$2.7 billion in 1982 and should fall to about \$2 billion this year or 3 percent of GNP (see table 4). For 1984-86, we expect the deficit will average about \$1.1

**Table 3**  
**South Korea: Projected Foreign**  
**Capital Needs**

*Billion US \$*

	1984	1985	1986
<b>Total</b>	<b>6.6</b>	<b>6.3</b>	<b>6.6</b>
Current account deficit	1.7	1.0	0.5
Principal repayments	3.0	3.4	3.9
Addition to reserves	0.5	0.5	0.8
Exports on credit	1.4	1.4	1.4

billion per year—only slightly above Seoul's projections. A substantial increase in oil prices or a faltering global recovery would push the deficit up considerably. [ ]

South Korean exports have picked up significantly since mid-1983 on the strength of the US recovery; as global demand increases, South Korea should be in a good position to expand its foreign sales. Korean competitiveness has been bolstered as a result of low domestic inflation and a gradual depreciation of the won. For 1984-86, we project exports will increase about 10 percent a year, roughly in line with government forecasts. Ships and electronics, which have outpaced export growth this year, will probably grow most rapidly. The United States should remain the largest market. [ ]

We expect imports will grow somewhat less rapidly than exports—about 8 percent a year. Energy conservation and Korea's large investment in heavy industry in the late 1970s to meet more of its machinery and equipment needs will begin to pay off. The services deficit, however, may expand slightly because of increasing interest payments and a decline in overseas construction revenue. [ ]

In contrast to a declining current account deficit, principal repayments will increase over the next three years. Amortization payments will rise from \$2.1

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**Table 4**  
**South Korea: Balance of Payments**

Million US \$

	1978	1979	1980	1981	1982	1983 <sup>a</sup>
Trade balance	-1,781	-4,395	-4,384	-3,628	-2,595	-2,000
Exports, f.o.b.	12,711	14,704	17,214	20,671	20,879	23,000
Imports, f.o.b.	14,491	19,100	21,598	24,299	23,474	25,000
Service balance	224	-195	-1,386	-1,518	-554	-500
Receipts	4,450	4,826	5,363	6,598	7,476	8,000
Payments	4,226	5,021	6,749	8,116	8,030	8,500
Net transfers	472	439	449	501	499	500
Current account	-1,085	-4,152	-5,321	-4,645	-2,650	-2,000
Net long-term capital	2,166	2,663	1,856	2,842	1,230	1,200
Net short-term capital	-1,171	844	1,945	-82	4	100
Errors and omissions	-312	-329	-369	-411	-1,295	-700
Overall balance	-402	-974	-1,889	-2,296	-2,711	-1,400
Foreign exchange reserves <sup>b</sup>	4,937	5,708	6,571	6,891	6,984	7,300

<sup>a</sup> Estimated.<sup>b</sup> Includes holdings of commercial banks.

billion in 1982 to \$3.9 billion in 1986 as principal on loans arranged in recent years falls due. Foreign exchange reserves are projected to increase about \$600 million annually to maintain a roughly two-and-a-half-month import cover. [ ]

#### Sources of Foreign Capital

On the basis of recent trends and known commitments, we believe official sources will provide about \$2 billion per year in foreign capital. Seoul should draw about \$1 billion annually from the World Bank and the Asian Development Bank and will draw part of its \$4 billion, seven-year commitment from Tokyo.<sup>4</sup> Foreign equity investment will probably only provide several hundred million dollars each year in foreign capital. As a result, Seoul will need to tap commercial banks for about \$4 billion a year in new credits during 1984-86. [ ]

<sup>4</sup> After almost two years of negotiations, Japan agreed in January 1983 to provide South Korea with \$4 billion in low-interest loans over seven years beginning in Japan FY 1982. Of the total, \$1.85 billion will be provided in Official Development Assistance (ODA) credits and the remainder in Export-Import Bank credits. The overall interest rate of the package is about 6 percent. [ ]

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[redacted] Manufactured goods account for more than 90 percent of South Korea's foreign sales, and Seoul has made dramatic progress in recent years expanding into new product lines, notably ships and iron and steel. In 1982 heavy industrial goods made up 52 percent of the country's manufactured exports, compared with 38 percent five years earlier. [redacted]

Any one of several economic events could undermine Seoul's efforts to obtain financing. An aborted global economic recovery, for example, would slow South Korea's export drive [redacted]

[redacted] Seoul is also vulnerable to a worldwide debt crisis [redacted]

[redacted] A rapid runup in oil prices could also throw the economic game plan off track. [redacted]

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[redacted] A failure of South Korea's push into skill-intensive industries is one example. Seoul is taking a risk in moving so heavily into more technology-intensive industries. It is counting on electronics, shipbuilding, and machinery products for most of the future expansion in foreign sales. Taiwan, Hong Kong, and Singapore are also moving into the same fairly narrow range of medium-technology products, and global demand may prove too small to accommodate this capacity. In addition, South Korea more and more will find itself competing with Japan in international markets in sectors where Japan has advantage in marketing and quality control. [redacted]

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[redacted] South Korea is able to tap international capital markets fairly easily. Seoul's most recent syndicated loans—a \$300 million credit for the Export-Import Bank this summer and a \$500 million loan for the Korea Development Bank (KDB) this fall reflect [redacted] confidence. Both were well received at favorable terms for South Korea; the LIBOR portion of the KDB loan, for example, carried a spread of 0.75 percentage point over LIBOR for the first six years and a spread of 0.875 percentage point for the last two years. In addition, Korean private firms have syndicated several loans in recent months with little trouble. [redacted]

A continuing series of major domestic financial scandals could also undermine creditor confidence. Three such scandals over the past two years and the financial difficulties of the country's overseas construction firms have created concern [redacted]

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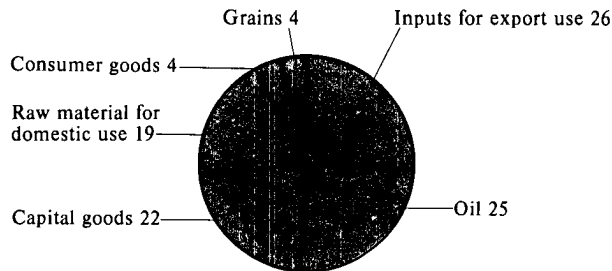
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**Figure 4**  
**South Korea: Import Composition, 1982**

Percent



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A shortfall in attracting foreign capital would force Seoul to make rapid adjustments in economic policy, which would have an extremely adverse impact on the outward-oriented Korean economy. We believe Seoul would respond quickly and with flexibility to a financing problem—but its options would be limited. Seoul initially would be forced to draw down foreign exchange reserves; such reserves at midyear 1983 amounted to \$6 billion, equal to about two-and-a-half-months' imports. After drawing down reserves, Seoul would have to curtail imports substantially. Because a large share of its foreign purchases are raw materials for its export products (26 percent), oil (25 percent), or capital equipment (22 percent), cutting imports would be difficult. Unlike many other LDCs, Seoul has little leeway to cut imports without immediately and substantially reducing economic growth. Only 4 percent of Korea's foreign purchases are consumer goods (see figure 4).

We believe the Chun government would put strong pressure on consumers and business to tighten their belts. Economic planners would probably reallocate

**Figure 5**  
**South Korea: Foreign Debt, by Holder, Yearend 1982**

Billion US \$

Total: 37.3

**Multilateral development institutions 4.5 (12%)**

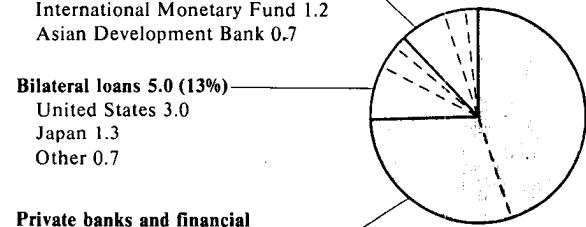
World Bank 2.6  
International Monetary Fund 1.2  
Asian Development Bank 0.7

**Bilateral loans 5.0 (13%)**

United States 3.0  
Japan 1.3  
Other 0.7

**Private banks and financial institutions 27.8 (75%)**

Non-US banks 16.8  
United States 11.0



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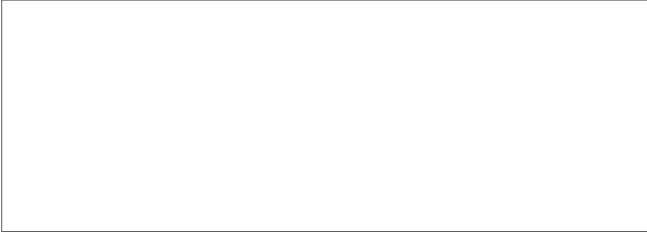
government spending in favor of projects that keep employment up but use few imports. Defense spending would probably be cut and import liberalization plans scrapped. Seoul would almost certainly put pressure on Washington and Tokyo to provide official assistance.

We cannot quantify the extent to which real GNP growth would decline as a result of a serious shortfall in foreign capital. Because the labor force is growing rapidly—almost 3 percent per year—unemployment would certainly increase significantly. Inflation would also accelerate with won depreciation as higher cost domestic products were substituted for imports.

**Implications for the United States**

Seoul would certainly look to Washington for official assistance in a foreign financing crisis and would point to US security interests in making its case.

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In addition to the heavy direct financial costs, a South Korean debt crisis would hurt the United States in other ways. South Korea is the ninth-largest market for US goods with purchases of \$6 billion in 1982. Seoul would be forced to curtail its imports, and the United States, as South Korea's leading supplier, would see sales to one of its major markets decline. The United States would also find it more difficult to persuade Seoul to continue with its import liberalization program.

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## Appendix

### Major Actors

#### The Borrowers

The South Korean Government and government-controlled institutions hold a dominant and growing share of the long-term debt, enabling Seoul to get more favorable financing terms and to coordinate its foreign obligations better. Since 1978, these institutions have accounted for almost 90 percent of the increase in the long-term foreign debt (see figure 6).

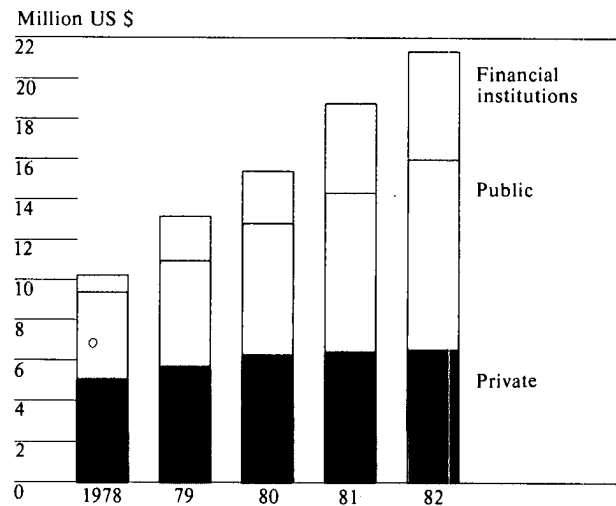
Borrowing by government-controlled financial institutions has grown especially rapidly; they have increased their share of the long-term debt from 8 percent in 1978 to 25 percent in 1982. These funds have been used for balance-of-payments support and for relending to the private sector. The Korea Development Bank and Korea Exchange Bank, in particular, have been major participants in the Eurodollar market. These institutions market several highly publicized loans each year (\$300-500 million), and the terms they receive set the standard for other Korean borrowers. The Korean Export-Import Bank has also become active in the Eurodollar market to support the country's export financing, particularly for ships.

The public sector's share of the long-term debt has remained in the 40- to 45-percent range over the past five years while the private sector's share has declined from about 50 percent to about 30 percent, partly because of slack domestic investment. Most of the private-sector debt is publicly guaranteed; as a result, the government bears a major share of the financial risk imbedded in South Korean foreign liabilities. Over the past two years, Seoul has covered the foreign obligations of several private firms that have gone bankrupt as a result of domestic financial scandals.

#### The Lenders

On the lending side, in contrast, private sources have accounted for a steadily increasing share of South Korea's long-term debt, holding almost two-thirds of the total in 1982. South Korea's more active participation in the Eurodollar market is responsible for a big boost in debt obligations to private commercial

**Figure 6**  
**South Korea: Long-Term Foreign Debt, by Sector**



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banks, particularly Japanese banks. Multilateral development banks, such as the World Bank and Asian Development Bank, nonetheless remain important sources of foreign funds. Borrowings from these institutions have financed infrastructure projects, vocational training facilities, and technological development projects. Seoul has tapped the World Bank's structural adjustment program for \$250 million, and a second loan for \$300 million is under negotiation. Credits from these institutions carry lower interest rates and longer maturities than private-sector loans and have helped hold down debt-servicing costs.

The International Monetary Fund (IMF) plays an important role in South Korea, not only by providing foreign funds for balance-of-payments support, but

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also by providing a stamp of approval to Seoul's economic policies. Since 1965, South Korea has signed 15 standby agreements with the IMF; Seoul owed the Fund \$1.2 billion at yearend 1982. In several instances, South Korea did not need IMF funds, but sought standby arrangements for the prestige such agreements give to the country's credit rating among commercial bankers. In 1982 no standby was signed because Seoul disagreed with IMF recommendations, especially concerning exchange-rate policy. This year, the IMF commended Korean policy prescriptions, and a \$600 million agreement was signed in July

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